Internal Revenue Service

memorandum

CC:TL-N-2687-90
Br1:HMLewis

date: FEB 15 1990

to: District Counsel, Nashville CC:NAS
Attn: E. Ford Holman, Jr.

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Estate of [redacted] deceased
Docket Number [redacted]

This is in response to you request dated January 8, 1990, for Tax Litigation Advice with respect to the above-captioned case.

ISSUE

Whether the income interest of the surviving spouse in [redacted] of the decedent's [redacted] residuary trusts are contingent on an election of Qualified Terminable Interest Property (QTIP) treatment by the decedent's executor and, if they are contingent, whether such contingency precludes the property interest in question from qualifying for the marital deduction.

CONCLUSION

The surviving spouse's interest in two trusts does not qualify for the QTIP election under I.R.C. § 2056(b)(7) because the surviving spouse's income interest in those trusts is contingent upon the executor's election to treat the residuary property in question as qualified terminable interest property. Accordingly, because the surviving spouse's interest was contingent, it is not treated as passing from the decedent to the surviving spouse. 2056-1000

FACTS

The deceased, [redacted], died on [redacted]. At the time of his death, the deceased was married to [redacted] and had children by that marriage, [redacted] and [redacted]. The deceased had been previously married to

[redacted] and had [redacted] children by that marriage, [redacted] and [redacted].

The decedent had executed a will, which provided for specific gifts. In Article IX of the will, the decedent provided for the disposition of the residue of his estate. Article IX 1a and 1b provide as follows:

> (a) If my wife survives me, my executor shall divide my residuary estate into four (4) separate parts. Part One (1) shall be designated the [redacted], and shall be an amount of property equal in value to the largest amount which, after allowing for the unified credit which has not been claimed for transfers made during my life, and any other allowable credits, will result in no federal estate taxes being imposed upon my estate. The remaining fraction of my residuary estate shall be equal in amount to the balance of my residuary estate, after deducting the amount allocated to the [redacted] as above described, and my executor shall divide this remaining fraction of my residuary estate into three (3) equal trusts, with each of such three (3) trusts to be designated and identified herein as the [redacted], and the [redacted]. It is my intention that the gift to the [redacted] shall not only qualify for the marital deduction, but shall be made only to the extent that it would cause a reduction in taxes payable under Chapter 11 of the Internal Revenue Code. In making those computations necessary to determine the amount of each of the trusts described hereinabove, the final determinations for federal estate taxes shall control. My executor shall distribute the [redacted] and the [redacted] to [redacted], or his successor, as Trustee, upon the trusts set forth below:
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> (b) My executor shall have complete discretion in the distribution of assets to the [redacted] and the [redacted] and the values used for such purposes, except that no asset or the proceeds from the sale thereof shall be

distributed to the [redacted] which would not qualify for the marital deduction and unproductive property shall not be allocated thereto without the consent of my wife. The property so allocated to the respective trusts shall have an aggregate fair market value fairly representative of the appreciation or depreciation in the value to the date or dates, of each distribution of all property when available for distribution. The exercise of the foregoing powers and discretion of my executor shall not be subject to question by any beneficiary of my estate.

Article IX 3d of the will provides:

(d) I hereby authorize my executor, in his sole discretion, to elect that any part of any amount of property passing under this Article to the [redacted] and/or [redacted] be treated as qualified terminable interest property for the purposes of qualifying for the marital deduction allowable in determining the federal estate tax upon my estate. Without limiting the discretion contained in the foregoing sentence, it is my expectation that my executor will make said election with respect to all of any such amount unless the timing of my wife's death and mine and the computation of the combined death duties in our two (2) estates render such an election inappropriate. To the extent that my executor does not effectively exercise the power of election granted hereunder, then such portion of the [redacted] and/or [redacted] shall be added to and commingled with the [redacted] and held, or distributed in whole or in part, as if it had been an original part of the [redacted].

Article IX 4 of the Will provides:

4. Upon the death of my wife after my death, the Trustee shall divide the [redacted] and the [redacted], as then constituted, or if my wife does not survive me, the Trustee shall distribute the [redacted] and the [redacted] to the [redacted]

> [redacted] to be added to and commingled with the [redacted] and held, as if it had been an original part of the [redacted].

A dispute arose among potential heirs concerning whether the decedent's domicile was the State of Arkansas or the State of Louisiana. If the decedent was domiciled in the State of Louisiana, the Louisiana Forced Heirs Law would entitle the decedent's first wife, [redacted], and children from his first marriage to assets that the Estate was passing on to [redacted], and on which it had claimed a marital deduction.

On [redacted], the Service issued a Notice of Deficiency.[1] Under the Explanation of Adjustments, the Service made various adjustments but only one addressed the marital deduction issue. However, it was a substantial adjustment. Paragraph (f) provided:

> It is determined that the marital deduction is limited to the amount which would pass to the surviving spouse in the event that certain claims by children of the decedent are successful. It is determined that under these circumstances $[redacted] would pass to the surviving spouse, rather than $[redacted] as reported. See Exhibit A. Accordingly, the taxable estate is increased $[redacted].

The Estate filed a petition in the United States Tax Court on [redacted],[2] and the Service filed its Answer on [redacted]. The Estate filed a Motion for Continuance on [redacted], pending the outcome of a civil suit brought by [redacted] and [redacted] against the Estate in the [redacted] and the outcome of a civil suit brought by [redacted] against the Estate in the [redacted]. In paragraph 4 of the motion, the Estate stated that if it is determined that the decedent was domiciled in Arkansas, little if any estate taxes would be due to the Service, but if the decedent was domiciled in Louisiana, substantial estate taxes would be due the Service. The Estate further stated, "[i]n either situation, it is contemplated that the issues in this case

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[1] See paragraph 2 of the Motion for Continuance in the United States Tax Court filed [redacted], by the Estate, the petitioner.

[2] We understand that the petition was timely mailed on [redacted].

will be settled between the parties without a trial of the cause before the United States Tax Court." The Tax Court granted the continuance on [redacted].

The District Court and state court lawsuits were settled before appeals were taken. Property awarded [redacted] apparently was treated as her share of community property based on the decedent and [redacted] living in Louisiana at the time of their divorce. The children, [redacted], received little more property than was provided for them in the will as a result of their lawsuit.

The case was sent to the Nashville Appeals Office for recomputation of the estate tax deficiency in accordance with the "local" court decisions. We understand that the Estate believes that the recomputation is not going to result in a significant increase in estate taxes. Because some of the litigation may have located additional assets, and because the estate desired face-to-face discussions, the case was returned to the Little Rock Estate Tax Attorney.

While reviewing the decedent's will for the above described purposes, the Estate Tax Attorney reread Article IX 3d which he had failed to give significance earlier. The Estate Tax Attorney, after considering the rationale and conclusion in TAM 8901003 (Sep. 9, 1988), has now determined that the bequests from the residuary estate to the [redacted] and the [redacted] fail to qualify for QTIP treatment under section 2056(b)(7). Accordingly, the Estate's claimed marital deduction would be lowered, and the taxable estate would be increased. A tentative tax computation supplied by an Appeals Officer shows that the deficiency would be at least [redacted] dollars, without consideration of the possible negative impact on the residue by the interest on the deficiency.

We understand that the Estate appeared to offer only limited resistance to the nonmarital deductions adjustments in the Notice of Deficiency. It appears that the Estate greatly inflated the decedent's corporate stock value, which seemed sure to pass to the surviving spouse under the estate tax marital deduction. The representative anticipated no estate tax consequences from inflating the stock value and knew that the higher that the Estate reported the date-of-death value for the stock, the higher the cost basis would be for capital gains purposes for any sales or dispositions made by the surviving spouse.

You anticipate that if we challenge the marital deduction for the QTIP election with respect to Trust 2 and Trust 3, the Estate will attempt to claim a drastically lower value for the decedent's corporate stock. Even if the Estate successfully

lowers the company stock value, you estimate the potential estate tax liability to exceed [redacted] dollars.

In addition to the legal issue in this matter, you request our advice concerning whether you should amend your Answer and pursue this failed QTIP issue in this case. You expect the Estate to oppose the amended answer and will claim that its settlements with [redacted] were made after relying on the position of the Service as set forth in the Notice of Deficiency and the Answer. You also anticipate that the Estate will ask for litigation costs in the event the government's position is not upheld.

ANALYSIS

QTIP Election

Section 2056(a) provides that, except as limited by subsection (b), the value of the taxable estate is determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes from the decedent to the surviving spouse.

Section 2056(b)(1) provides the general rule that no deduction is allowed if a nondeductible terminable interest passes from the decedent to the surviving spouse. Generally, an interest in property is a nondeductible terminable interest where, on the occurrence of an event, an interest passing to the surviving spouse will terminate and an interest in the property passes (for less than an adequate and full consideration in money or money's worth) from the decedent to another person.

Prior to the Economic Recovery Tax Act of 1981, which created section 2056(b)(7), the decedent had to give the spouse either an outright bequest or a general power to appoint the property to whomever the spouse wished in order to support a marital deduction by the estate. In section 2056(b)(7), Congress created a new type of interest in property, the QTIP, which will qualify for the estate tax marital deduction. The most important change that this new concept represents is that for estates of decedents dying after 1981, and gifts made after that date (section 2523(f)), the surviving or donee spouse does not have to be given control over ultimate disposition of the transferred property in order for the estate to obtain the marital deduction.

Section 2056(b)(7)(A) provides in general that in the case of qualified terminable interest property (i) for purposes of subsection (a), such property shall be treated as passing to the surviving spouse, and (ii) for purposes of paragraph (1)(A), no part of such property shall be treated as passing to any person other than the surviving spouse.

Section 2056(b)(7)(B) provides that for purposes of this paragraph:

> (i) In general.- The term "qualified terminable interest property" means property (I) which passes from the decedent, (II) in which the surviving spouse has a qualifying income interest for life, and (III) to which an election under this paragraph applies.
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> (ii) Qualifying income interest for life.- The surviving spouse has a qualifying income interest for life if (I) the surviving spouse is entitled to all the income from the property, payable annually or at more frequent intervals, or has a usufruct interest for life in the property, and (II) no person has a power to appoint any part of the property to any person other than the surviving spouse.

The principles in Treas. Reg. § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, are applicable. That section provides, in part, that an interest passing in trust fails to satisfy the condition that the spouse be entitled to all the income, to the extent that the income is required to be accumulated in whole or in part or may be accumulated in the discretion of any person other than the surviving spouse; to the extent that the consent of any person other than the surviving spouse is required as a condition precedent to distribution of the income; or to the extent that any person other than the surviving spouse has the powers to alter the terms of the trust so as to deprive the surviving spouse of the right to the income.

Prop. Treas. Reg. § 20.2056(b)-(7)(c)(1) provides that, in general, for purposes of this section, the term "qualifying income interest for life" means (i) the surviving spouse is entitled for life to all the income from the property, payable annually or at more frequent intervals, and (ii) no person (including the surviving spouse) has a power, other than a power the exercise of which takes effect only at or after the surviving souse's death, to appoint any part of the property to any person other than the surviving spouse. The proposed regulation further provides:

> In general, the principles outlined in § 20.2056(b)-(5)(f), relating to whether the spouse is entitled for life to all of the income from the entire interest or specific portion of the entire interest, are applicable in determining whether the

> surviving spouse is entitled for life to all the income from the property, regardless of whether the interest passing to the spouse is in trust. An income interest created for a term of years, or a life estate subject to termination upon the occurrence of a specified event (e.g., remarriage) is not a qualifying income interest for life. In addition, an income interest (or life estate) that is contingent upon the executor's election under paragraph (b)(3) of this section is not a qualifying income interest for life, regardless of whether the election is actually made. (Underscoring supplied.)

In Estate of Bowling v. Commissioner, 93 T.C. 286 (1989), the Tax Court considered a situation in which a testamentary trust, which funded a surviving spousal annuity, granted the trustee power to invade trust corpus during the life of the surviving spouse for the emergency needs not only of the surviving spouse but also of decedent's surviving son and brother. The Service asserted that some of the trust property could have passed to someone other than the surviving spouse during the surviving spouse's life and that the trust property does not qualify as QTIP property with respect to which a marital deduction is allowed. The Tax Court held that the interest passing to decedent's surviving spouse was not a qualifying income or annuity interest.

In Estate of Montgomery v. Commissioner, T.C. Memo. 1988-457, the estate had taken a marital deduction consisting of two separate parts, the second of which was the QTIP. The issue in this case concerned whether the QTIP interest had "passed" to the surviving spouse. The Tax Court stated:

> [W]e have given the word "passing" the same broad meaning as is set forth in section 2056(c). * * * In [Parker v. Commissioner, 62 T.C. 192 (1974)] the Court explicitly stated that "We do not think the words 'passes or has passed,' * * * can be equated with 'distributed.'" Parker, 61 T.C. at 197.
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> * * *
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> Given the usual technical meaning accorded the term "pass" in a will, as distinguished from transfer or distribute, there can be no doubt that the interest in the QTIP passed to decedent's wife. It devolved to her under the terms of decedent's will, regardless of whether it was distributed.

In the instant case, [redacted]'s income interest in Trust 2 and Trust 3 could only come into existence upon a QTIP election made by the executor with respect to all or a portion of the assets in the residuary estate at the time of the decedent's death. If no election was made by the executor, then [redacted] would have had no right to any part of the income or corpus with respect to the assets that were used to fund Trust 2 and Trust 3. If no election was made, those assets, under the terms of the will, were to be added to and commingled with the [redacted], as if it had been an original part of the [redacted].

Therefore, [redacted]'s interest in Trust 2 and Trust 3 is derived by reason of the executor's election rather than by reason of a transfer by the decedent exclusively to the surviving spouse. Consequently, [redacted]'s interest in Trust 2 and Trust 3 did not pass from the decedent to the surviving spouse for purposes of section 2056.

[redacted]'s interest in Trust 2 and Trust 3 did not devolve directly to her from the decedent's will as was the situation in Estate of Montgomery. It required an election that was in the discretion of the executor, and if the executor failed to make the election, then someone other than the surviving spouse would be entitled to the income or corpus during the life of the surviving spouse. The Tax Court in Estate of Bowling, supra, and in Estate of Higgins v. Commissioner, 91 T.C. 61, 68 (1988), recognized that one of the conditions for a QTIP election is that no one other than the surviving spouse has a power to appoint any part of the property to any person other than the surviving spouse.

The situation in the instant case differs from a situation in which the will provides that a spousal annuity trust will be funded but gives the executor the discretion to make the QTIP election. In that case, the spouse is still entitled to the income from the trust even if the executor fails to make the QTIP election.

In addition, Prop. Treas. Reg. § 20.2056(b)-(7)(c)(1) provides that an income interest (or life estate) that is contingent upon the executor's election under paragraph (b)(3) is not a qualifying income interest for life, regardless of whether the election is actually made. We recognize the general position of the Tax Court that proposed regulations are not authority because they have not been formally adopted by the Commissioner and that they "carry no more weight than a position advanced on brief by the respondent." F.W. Woolworth Co. v. Commissioner, 54 T.C. 1233, 1265-1266 (1970). However, we believe that this proposed regulation merely sets forth the case law adopted by the Tax Court and follows the clear language of the statute.

Accordingly, based on the information presented, we conclude that [redacted] did not receive a qualifying income interest for life in any of the assets in Trust 2 and Trust 3, and that no portion of either Trust 2 or Trust 3 qualifies for the section 2056(b)(7) election. Therefore, the Estate was not entitled to claim a marital deduction with respect to the value of the assets placed in Trust 2 and Trust 3.

Amended Answer

T.C. Rule 142(a) provides that, in general, the burden of proof shall be upon the petitioner, except as otherwise provided by statute or determined by the Tax Court; and except that, in respect of any new matter, increases in deficiency, and affirmative defenses, pleaded in his answer, it shall be upon the respondent.

The Service took a protective position in the Notice of Deficiency and disallowed the entire claimed marital deduction. In an amended answer, we would be denying only two-thirds of the claimed marital deduction. However, in the Notice of Deficiency, we based the disallowance "in the event that certain claims by children of the decedent are successful." Our amended answer would be based on the fact that [redacted] did not have a qualifying income interest for life as defined in section 2056(b)(7)(B)(ii) because the executor had a power to appoint a part of the property in Trust 2 and Trust 3 to a person other than [redacted]. Accordingly, we believe that the Tax Court would consider this a new matter and that the Service would bear the burden of proof.

You ask whether the Tax Court will allow the government to amend its Answer at this late date to affirmatively allege the new basis for denial of the marital deduction. We cannot speculate on whether the Tax Court will allow the amended answer. However, amended answers are freely granted in the interest of justice when there is no surprise or prejudice to the other party. See T.C. Rule 41(a). We believe that the petitioner has sufficient time to develop the case before trial.

We note that the Estate is the party that asked for the continuance; no discovery has been done; no trial has been conducted; no briefs were filed by either party; the issue is clear, i.e. the petitioner will either win or lose this case on a determination of whether the executor could direct the assets in question to someone other than [redacted] during her lifetime; you do not expect a calendar call in [redacted] before early [redacted]; the amount of deficiency is substantial even if the petitioner was successful in having the value of the corporate stock reduced; and it appears that our case is strong. Accordingly, we recommend that you file a motion to allow an amended answer unless you believe that the petitioner can win on the merits, i.e., the petitioner can demonstrate that the

executor did not have discretion under the law of Arkansas[3] to withhold the funding of Trust 2 and Trust 3.

We anticipate that the Estate will attempt to rebut our assertion that the executor had the discretion not to fund Trust 2 and Trust 3 and could place the residuary amounts in the [redacted]. In general, we will argue that Article IX 3d clearly states that "the sole discretion" for making the election and for determining the amounts that are used to fund Trust 2 and Trust 3 rests with the executor. If the executor fails to make the election the funds are added to the [redacted]. Article IX 1b provides that the executor has complete discretion in the distribution of assets to and the values used for the funding of the [redacted] and the [redacted] and that the exercise of those powers and discretion are not subject to question by any beneficiary of the Estate. Article XIII 2 provides that to the extent that any such requirement can be legally waived, no executor is required to give any bond as such executor. Thus, it appears that the decedent wanted the executor to have great discretion without worry of personal liability and not be subject to influence by the beneficiaries.

The Estate will probably assert that under Article IX 3d the executor was bound to make the election and fund Trust 2 and Trust 3 because "it was [the decedent's] expectation that [the] executor will make said election" unless the timing of [redacted]s death and the computation of the combined death duties in the two estates rendered such an election inappropriate. We expect that the Estate will argue that because [redacted] did not die soon after the decedent the executor was required to make the election and fund Trust 2 and Trust 3. Thus, he did not have discretion.

Although we do not believe that the Estate has a strong argument, this matter is not without litigating hazards. The courts have strained language of wills to allow a deduction if they believe that the estate was victimized by bad estate tax planning, i.e., the estate could have received the deduction if the drafter of the will had done it correctly. See e.g., Estate of Richardson v. Commissioner, 89 T.C. 1193 (1987) and Parasson v. United States, an unreported opinion, 87-1 U.S.T.C. ¶ 13,708, (N.D. Ohio 1987).

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[3] Mr. E. Ford Holman advised that he believes the interpretation of the will is controlled by Arkansas law. He believes that this is in keeping with the litigation and settlement among the heirs.

Litigation Costs

You also state because of an amendment at such a late date, you anticipate the award of litigation costs in the event the government's position is not upheld.

The Estate filed its petition on [redacted]. Effective with respect to civil tax litigation begun after December 31, 1985, and before November 11, 1988, section 7430 provides that the "prevailing party" in any civil proceeding brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under the Internal Revenue Code may be awarded a judgment for reasonable litigation costs incurred in such proceeding. To be eligible for an award of litigation costs, taxpayers must meet two requirements: (1) They must satisfy the statutory definition of prevailing party and (2) they must exhaust all administrative remedies available to them.

Section 7430(c)(4)(A) (which was designated section 7430(c)(2)(A) at the time of the filing of the petition) provides that, in general, the term "prevailing party" means any party which establishes that the position of the United States was not substantially justified and which has substantially prevailed with respect to the amount in controversy or with respect to the most significant issue or set of issues presented. In addition, at the time of the filing of the petition, the net worth of the party seeking the award must not exceed two million dollars for an individual or seven million dollars for any other party.

We do not believe that we should allow the potential for a litigation cost award to determine whether we should seek an amended answer in the instant case. First, we believe that we should prevail if the Tax Court allows us to file an amended answer. Even if the Tax Court does not sustain our new position, we do not believe that the Estate can demonstrate that the position of the United States was not substantially justified. Further, from our discussions with Mr. Holman, we do not believe that the Estate can meet the net worth test.[4]

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[4] The current Service position is that if an estate is a party to litigation, then its net worth cannot exceed two million dollars at the time the civil action was filed. However, the U.S. District Court for the Western District of Missouri held that the proper net worth test for an estate is seven million dollars. See Boatman's First National Bank v. United States, Civil Action No. 87-0809-CV-W-1, (W.D. Mo. Oct. 17, 1989), (copy attached.) We have also attached a copy of a letter dated December 22, 1989, to the Department of Justice, in which we recommend appeal in that case.

If you have any question concerning this matter, please contact Harve M. Lewis at FTS 566-4189.

MARLENE GROSS

By: Richard L. Carlisle
RICHARD L. CARLISLE
Senior Technician Reviewer
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Attachments

Boatman's First National Bank
Letter to Dept. of Justice